

## Management's Discussion and Analysis

As managers of the state of Washington, we offer this narrative overview and analysis of the financial activities for the fiscal year ended June 30, 2003. We present this information in conjunction with the information included in our letter of transmittal, which can be found preceding this narrative, and with the state's financial statements, which follow. All amounts, unless otherwise indicated, are expressed in thousands of dollars.

### Financial Highlights

- Total assets of the state of Washington exceeded its liabilities by \$14.9 billion (reported as *net assets*). Of this amount, \$1.5 billion was reported as "unrestricted net assets." Unrestricted net assets represent the amount available to be used to meet the state's ongoing obligations to citizens and creditors.
- The state of Washington's governmental funds reported combined ending fund balances of \$7.2 billion, an increase of \$70 million in comparison with the prior year.
- Unreserved fund balance for the General Fund was \$404 million, or 2.5 percent of total General Fund expenditures.
- The state's capital assets increased by \$1.3 billion while total bond debt increased by \$875 million during the current fiscal year.

### Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the state of Washington's basic financial statements. The state of Washington's basic financial statements include three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. The focus is on both the state as a whole (government-wide) and the major individual funds. The dual perspectives allow the reader to address relevant questions, broaden a basis for comparison (year to year or government to government) and enhance the state's accountability.

**Government-wide Financial Statements** - The *government-wide financial statements* are designed to provide readers with a broad overview of the state of Washington's finances, in a manner similar to a private sector business.

The *Statement of Net Assets* presents information on all of the state of Washington's assets and liabilities, with the difference between the two reported as *net assets*. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the state of Washington is improving or deteriorating.

The *Statement of Activities* presents information showing how the state's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, *regardless of the timing of related cash flows*. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave). The Statement of Activities is focused on both the gross and net cost of various activities (including governmental, business-type and component unit). This is intended to summarize and simplify the reader's analysis of the revenues and costs of various state activities and the degree to which activities are subsidized by general revenues.

Both of the government-wide financial statements distinguish functions of the state of Washington that are principally supported by taxes and intergovernmental revenues (*governmental activities*) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (*business-type activities*). The governmental activities of the state of Washington include education, human services, transportation, natural resources, adult corrections and general government. The business-type activities of the state of Washington include the workers' compensation, unemployment compensation and health insurance programs, as well as various higher education student services such as housing and dining.

The government-wide financial statements can be found on pages C15 – C19 of this report.

**Fund Financial Statements** - A *fund* is a grouping of related accounts used to maintain control over resources that are segregated for specific activities or objectives. The state of Washington, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the state can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds.

**Governmental Funds.** *Governmental funds* are used to account for essentially the same functions reported as *governmental activities* in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on *near-term inflows and outflows of spendable resources*, as well as on *balances of spendable resources* available at the end of the fiscal year. Such information may be useful in evaluating a government's near term financing requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for *governmental funds* with similar information presented for *governmental activities* in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between *governmental funds* and *governmental activities*.

Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balances for three major funds and an aggregate total for all non-major funds. The state's major governmental funds are the General Fund, Higher Education Special Revenue Fund, and the Higher Education Endowment Permanent Fund. Individual fund data for each of the non-major governmental funds is provided in the form of *combining statements* elsewhere in this report.

The governmental fund financial statements can be found on pages C21 – C24 of this report.

**Proprietary Funds.** - The state of Washington maintains two different types of proprietary funds. *Enterprise funds* are used to report the same functions presented as *business-type activities* in the government-wide financial statements. *Internal service funds* represent an accounting device used to accumulate and allocate costs internally among the state of Washington's various functions. The state of Washington uses internal service funds to account for general services such as motor pool, central stores, data processing services, and printing services. Because internal service funds predominately benefit governmental rather than business-type functions, they have been included within *governmental activities* in the government-wide financial statements.

Proprietary fund financial statements provide the same type of information as the government-wide financial statements, but in greater detail. The proprietary fund financial statements provide separate information for Workers Compensation and Unemployment Compensation Funds, which are considered to be major funds, as well as an aggregated total for all non-major enterprise funds. The internal service funds are combined for presentation purposes. Individual fund data for the state's non-major proprietary funds are provided in the form of *combining statements* elsewhere in this report.

The proprietary fund financial statements can be found on pages C26 – C29 of this report.

***Fiduciary Funds.*** Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are *not* reflected in the government-wide financial statement because the resources of those funds are *not* available to support the state of Washington’s own programs. Washington’s fiduciary funds include state administered pension plans. The accounting used for fiduciary funds is much like that used for proprietary funds.

The fiduciary fund financial statements can be found on pages C30 – C31 of this report.

***Component Units.*** Component units are entities which are legally separate from the state but which are financially accountable to the state. The state has one major component unit, the Washington State Public Stadium Authority, and four non-major component units. Refer to Note 1 on pages C36 and C37 for more detailed information.

The financial statements for the state’s component units can be found on pages C32 – C33 of this report.

***Notes to the financial statements.*** The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages C34 – C88 of this report.

***Other required information.*** In addition to this discussion and analysis, this report also presents required supplementary information on budgetary comparisons, pension plan funding, and infrastructure assets reported using the modified approach. Required supplementary information can be found on pages C89 – C108 of this report.

The combining statements referred to earlier are presented immediately following the required supplementary information. Combining and individual fund statements and schedules can be found on pages 127-185 of the Comprehensive Annual Financial Report (CAFR).

## **Government-wide Financial Analysis**

As noted earlier, net assets may serve over time as a useful indicator of a government’s financial position. For the state of Washington, total assets exceed liabilities by \$14.9 billion at June 30, 2003 as compared to \$15.0 billion at June 30, 2002.

The largest portion of the state’s net assets (64.3 percent for Fiscal Year 2003 as compared to 57.5 percent for Fiscal Year 2002) reflects its investment in capital assets (e.g., land, buildings, machinery, and equipment), less any related debt used to acquire those assets that is still outstanding. The state of Washington uses these capital assets to provide services to citizens; consequently, these assets are *not* available for future spending. Although the state of Washington’s investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

## State of Washington's Net Assets

(in millions of dollars)

	Governmental Activities		Business-type Activities		Total	
	2003	2002	2003	2002	2003	2002
Current and other assets	\$ 12,155	\$ 11,682	\$ 14,919	\$ 13,405	\$ 27,074	\$ 25,087
Capital assets	20,110	18,957	1,280	1,114	21,390	20,071
Total assets	<u>32,265</u>	<u>30,639</u>	<u>16,199</u>	<u>14,519</u>	<u>48,464</u>	<u>45,158</u>
Long-term liabilities outstanding	10,070	9,491	18,140	16,460	28,210	25,951
Other liabilities	3,341	3,005	2,027	1,234	5,368	4,239
Total Liabilities	<u>13,411</u>	<u>12,496</u>	<u>20,167</u>	<u>17,694</u>	<u>33,578</u>	<u>30,190</u>
Net assets:						
Invested in capital assets, net of related debt	9,033	8,253	543	355	9,576	8,608
Restricted	2,283	2,153	1,514	1,883	3,797	4,036
Unrestricted	7,538	7,737	(6,025)	(5,413)	1,513	2,324
Total net assets	<u>\$ 18,854</u>	<u>\$ 18,143</u>	<u>\$ (3,968)</u>	<u>\$ (3,175)</u>	<u>\$ 14,886</u>	<u>\$ 14,968</u>

A portion of the state of Washington's net assets (25.5 percent for Fiscal Year 2003 as compared to 27.0 percent for Fiscal Year 2002) represents resources that are subject to constitutional or external restrictions on how they may be used. The remaining balance of *unrestricted net assets* may be used to meet the state's ongoing obligations to citizens and creditors.

### State of Washington's Changes in Net Assets

(in millions of dollars)

	Governmental Activities		Business-type Activities		Total	
	2003	2002	2003	2002	2003	2002
Program revenues:						
Charges for services	\$ 2,801	\$ 2,906	\$ 5,439	\$ 4,987	\$ 8,240	\$ 7,893
Grants and contributions	7,716	7,182	830	269	8,546	7,451
Total revenues	10,517	10,088	6,269	5,256	16,786	15,344
Program expenses:						
General government	(812)	(997)	-	-	(812)	(997)
Education - K-12	(5,960)	(5,747)	-	-	(5,960)	(5,747)
Education - higher education	(3,750)	(3,920)	-	-	(3,750)	(3,920)
Human services	(8,971)	(8,903)	-	-	(8,971)	(8,903)
Adult corrections	(658)	(600)	-	-	(658)	(600)
Natural resources and recreation	(732)	(564)	-	-	(732)	(564)
Transportation	(1,422)	(1,264)	-	-	(1,422)	(1,264)
Intergovernmental grants	(341)	(350)	-	-	(341)	(350)
Interest on long-term debt	(415)	(578)	-	-	(415)	(578)
Workers' compensation	-	-	(2,617)	(2,147)	(2,617)	(2,147)
Unemployment compensation	-	-	(2,329)	(1,872)	(2,329)	(1,872)
Health insurance programs	-	-	(912)	(810)	(912)	(810)
Higher education student services	-	-	(1,051)	(994)	(1,051)	(994)
Other business-type activities	-	-	(937)	(924)	(937)	(924)
Total expenses	(23,061)	(22,923)	(7,846)	(6,747)	(30,907)	(29,670)
Net program expenses over revenues	(12,544)	(12,835)	(1,577)	(1,491)	(14,121)	(14,326)
General revenues:						
Taxes	12,202	12,030	86	83	12,288	12,113
Interest and investment earnings	252	189	1,317	613	1,569	802
Excess(deficiency) of revenues over expenses before contributions to endowments and transfers	(90)	(616)	(174)	(795)	(264)	(1,411)
Contributions to endowments	36	29	-	-	36	29
Transfers	619	148	(619)	(148)	-	-
Increase(decrease) in net assets	565	(439)	(793)	(943)	(228)	(1,382)
Net assets - July 1, as restated	18,289	18,582	(3,175)	(2,232)	15,114	16,350
Net assets - June 30	\$ 18,854	\$ 18,143	\$ (3,968)	\$ (3,175)	\$ 14,886	\$ 14,968

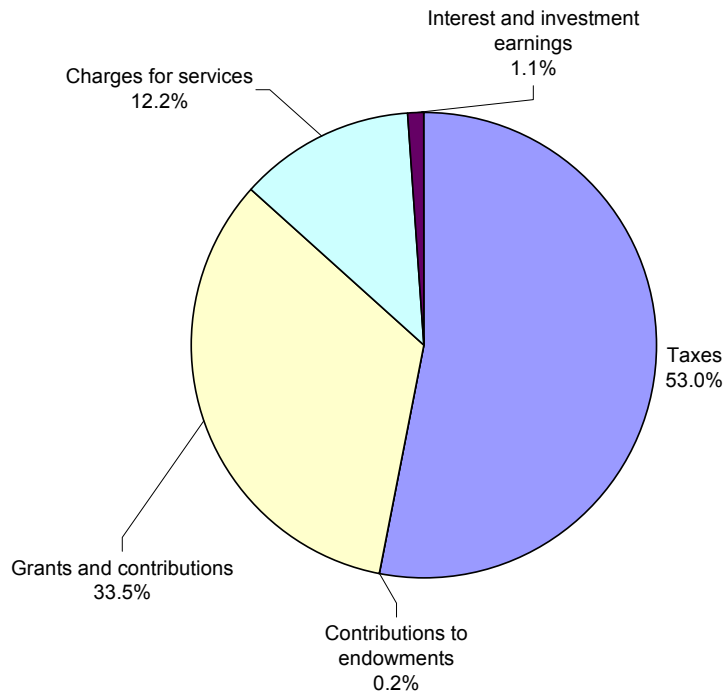
Note: Increase in beginning net assets of \$146 million for fund-type reclassifications.

As previously mentioned, the state's activities are divided between governmental and business-type. The majority of support for governmental activities comes from taxes and intergovernmental grants, while the business-type activities are supported primarily through user charges.

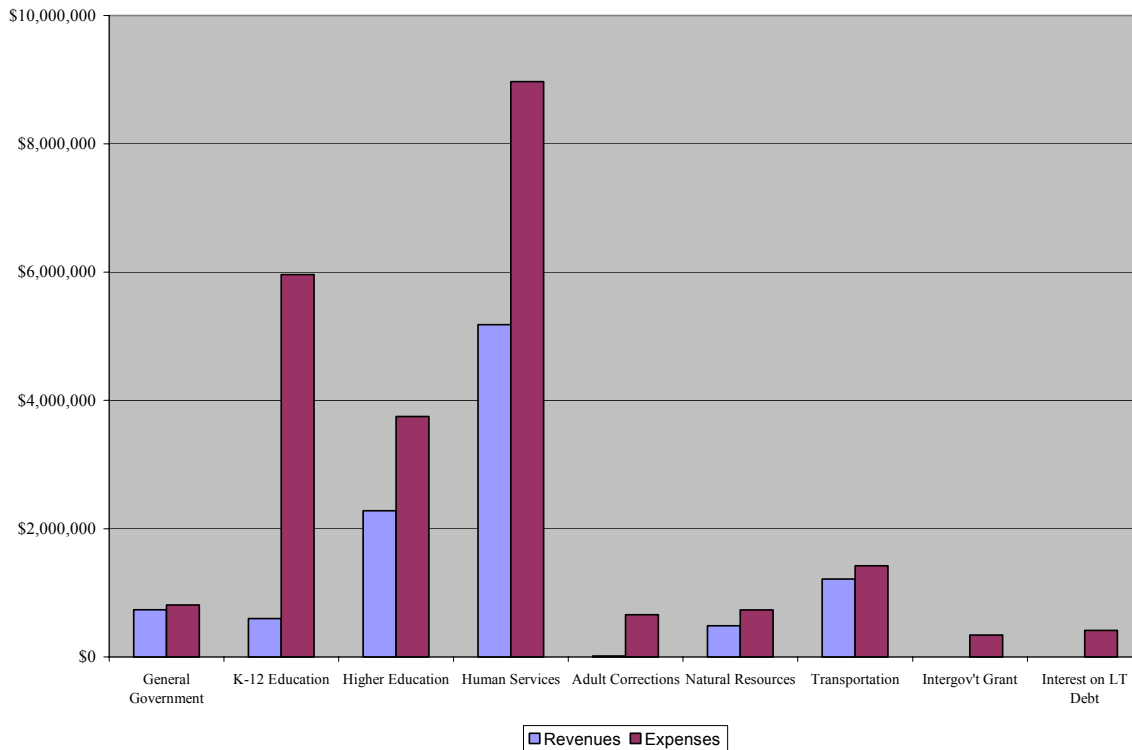
**Governmental activities.** Governmental activities resulted in a net increase in the state of Washington's net assets of \$711 million. Key elements of this increase are as follows:

- A transfer from the Tobacco Settlement Authority to the General Fund of \$450 million.
- Receipt of \$141 million in fiscal relief payments under the Federal Jobs and Growth Tax Relief Reconciliation Act of 2003.

## Revenues by Source – Governmental Activities



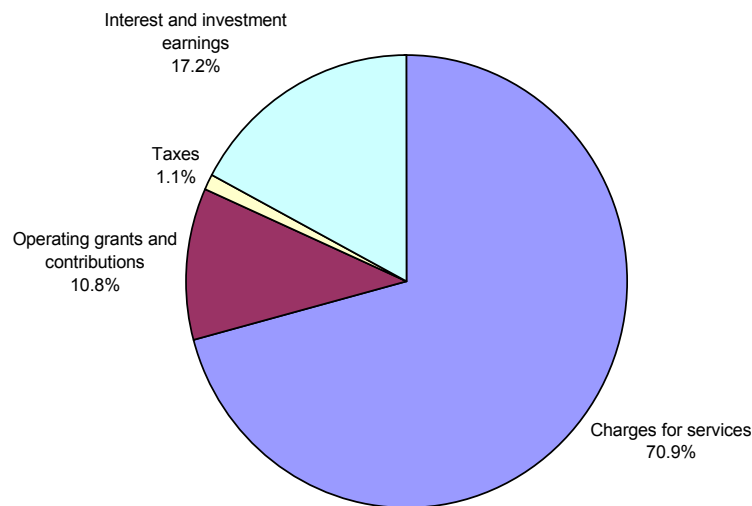
## Expenses and Program Revenues - Governmental Activities



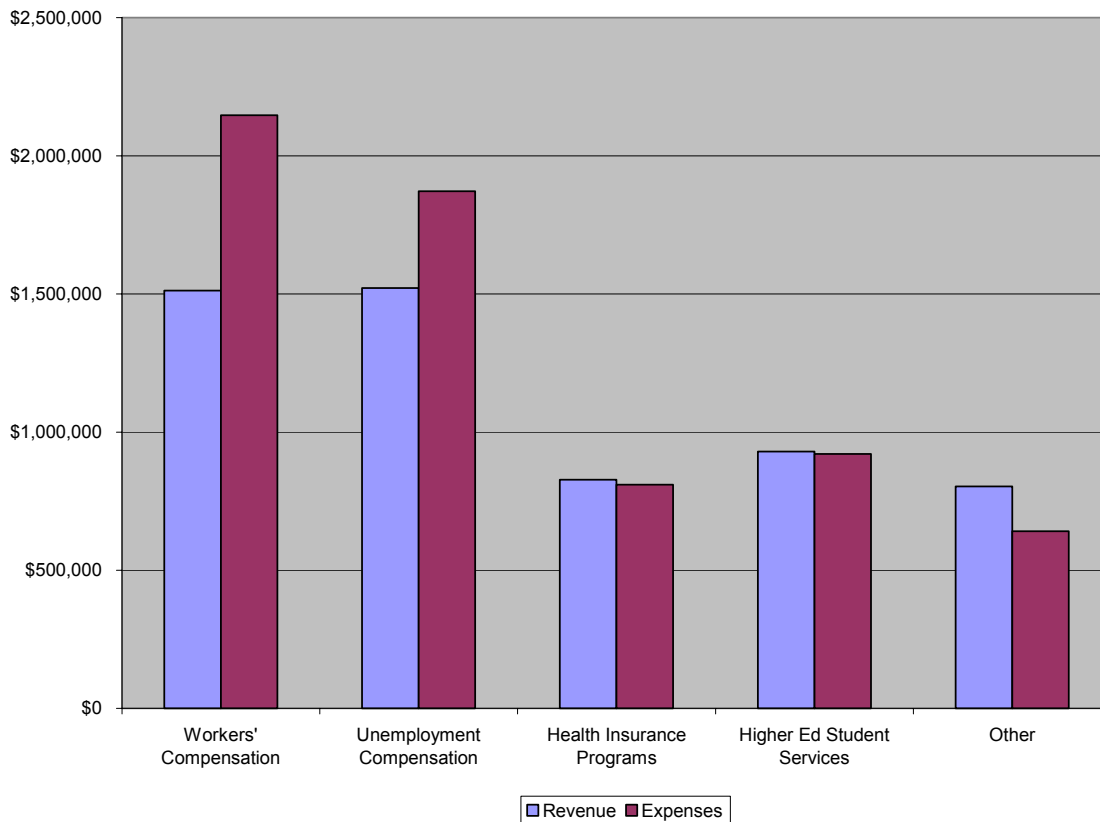
***Business-type activities.*** Business-type activities decreased the state of Washington's net assets by \$793. The main causes of this decrease are as follows:

- The workers' compensation program experienced a loss. By law, the supplemental pension cost-of-living adjustments granted for time-loss and disability payments are funded on a pay-as-you-go basis while the related costs are recognized at the time the injury occurs.
- High levels of unemployment related to the state's economic recession resulted in unemployment compensation benefit payments exceeding unemployment compensation assessment revenue.
- The transfer from the Tobacco Settlement Authority, a blended business-type component unit, to the General Fund of \$450 million.

### Revenues by Source – Business-type Activities



### Expenses and Program Revenues – Business-type Activities



### Financial Analysis of the Government's Funds

As noted earlier, the state of Washington uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

**Governmental Funds.** As discussed earlier, the focus of the state of Washington's *governmental funds* is to provide information on near-term inflows, outflows, and balances of *spendable* resources. Such information is useful in assessing the state of Washington's financing requirements. In particular, *unreserved fund balance* may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

The General Fund is the chief operating fund of the state of Washington. At the end of the fiscal year, total fund balance for the General Fund equaled \$1.37 billion. Unreserved fund balance, the amount considered available to spend, totaled \$404 million. \$908 million of the General Fund fund balance relates to certain accrued revenues and has been designated for working capital purposes. It is not considered available to spend.

The fund balance of the state of Washington's General Fund increased by \$31 million during the current fiscal year.

## State of Washington's General Fund

(in millions of dollars)

	Fiscal Year 2003	Fiscal Year 2002	Difference Increase (Decrease)
Revenues			
Taxes	\$ 10,610	\$ 10,342	\$ 268
Federal grants	5,354	5,131	223
Investment revenue	36	20	16
Other	498	413	85
Total	16,498	15,906	592
Expenditures			
Human services	8,538	8,304	234
Education	6,911	6,778	133
Other	890	910	(20)
Total	16,339	15,992	347
Net transfers in (out)	(139)	(65)	(74)
Other financing sources	11	7	4
Net increase(decrease) in fund balance	\$ 31	\$ (144)	\$ 175

The state's recession is reflected in fairly static tax revenues. Expenditure growth was limited to services and programs most vital to citizens – primarily health care, public education and economic development.

Activity for the non-major governmental funds resulted in a reduction of net assets of \$289 million. Actual non-major governmental fund revenue decreased by \$28 million in Fiscal Year 2003 compared with Fiscal Year 2002. This revenue reduction combined with an increased demand for services to result in a use of or decrease of net assets.

**Proprietary Funds.** The state of Washington's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail.

The Workers' Compensation Fund and the Unemployment Compensation Fund are major proprietary funds. Both experienced losses in Fiscal Year 2003 that are discussed previously under business-type activities. Activity for the various non-major proprietary funds resulted in a decrease to net assets of \$238 million. This loss is primarily attributable to the Tobacco Settlement Authority (TSA), which is a blended component unit of the state. The TSA issued bonds in Fiscal Year 2003 and transferred \$450 million to the state in exchange for 29.2 percent of the state's tobacco settlement revenue stream. Because the revenue stream is a contingent asset and, according to accounting standards, can not be recognized until received, the TSA reported a Fiscal Year 2003 loss of \$441 million. Additionally, the Risk Management Fund, an internal service fund, ended Fiscal Year 2003 with a loss of \$89 million. This loss resulted because funding for claims is provided on a pay-as-you-go basis while the claims expense is recorded as claims are incurred.

## General Fund Budgetary Highlights

Differences between the General Fund original budget and the final amended budget reflect adjustments to deal with the state's recession and are summarized as follows:

- Estimated tax revenues were decreased \$693 million.
- Resources provided by transfers in from other funds increased \$838 million.
- Appropriated expenditures decreased by \$404 million.

Actual expenditures in the General Fund were \$407 less than the final amended budget.

## Capital Asset, Infrastructure, Bond Debt Administration, and Subsequent Events

**Capital assets.** The state of Washington's investment in capital assets for its governmental and business type activities as of June 30, 2003, amounts to \$21.4 billion (net of accumulated depreciation). This investment in capital assets includes land, infrastructure, museum and historical collections, buildings and other improvements, furnishings and equipment, as well as construction in progress.

Washington's Fiscal Year 2003 investment in capital assets, net of current year depreciation, was \$1.3 billion, including increases to the state's highway infrastructure of \$631 million and buildings of \$485 million. The state's construction in progress includes both new construction and major improvements to state facilities including correctional facilities, ferry vessels and terminals, and buildings on the capitol and college and university campuses. Remaining commitments on these construction projects total \$2.2 billion.

Additional information on the state of Washington's capital assets can be found in Note 6 beginning on page C53 of this report.

### State of Washington's Capital Assets (net of depreciation) (in millions of dollars)

	Governmental Activities		Business-type Activities		Total	
	2003	2002	2003	2002	2003	2002
Land	\$ 1,133	\$ 1,088	\$ 84	\$ 24	\$ 1,217	\$ 1,112
Highway system infrastructure and other assets not depreciated	11,839	11,174	-	-	11,839	11,174
Buildings	4,035	3,716	828	662	4,863	4,378
Furnishings, equipment and collections	1,287	1,250	88	85	1,375	1,335
Other improvements and miscellaneous	653	588	42	43	695	631
Construction in progress	1,163	1,141	238	300	1,401	1,441
Total	<u>\$ 20,110</u>	<u>\$ 18,957</u>	<u>\$ 1,280</u>	<u>\$ 1,114</u>	<u>\$ 21,390</u>	<u>\$ 20,071</u>

**Infrastructure.** The state of Washington first reported infrastructure under the requirements of the Governmental Accounting Standards Board in Fiscal Year 2002. Transportation infrastructure reported includes the State Highway System, Emergency Airfields and a short rail line. While the rail line is reported net of depreciation, the State Highway System and Emergency Airfields are reported using the Modified Approach. Under the Modified Approach, rather than recording depreciation, asset condition is reported. The condition of

these assets, along with their rating scales for pavements, bridges and air fields are further explained in the notes and required supplementary information to the financial statements.

The Department of Transportation accomplished a net addition of 39 lane miles and 16 new bridges in Fiscal Year 2003. The reported value of the State Highway System increased by \$631 million during the fiscal year. The State Highway System and Emergency Airfields continue to meet established condition levels. No significant changes in condition levels were noted for pavements or bridges. Amounts spent during Fiscal Year 2003 to maintain/preserve these infrastructure assets did not vary significantly from estimated spending plans according to the biennial budget.

Commitments made for infrastructure projects that extend beyond the fiscal year amount to \$651 million representing 843 projects.

**Bond debt.** At the end of Fiscal Year 2003, the state of Washington had general obligation bond debt outstanding of \$8.5 billion, an increase of 4 percent over Fiscal Year 2002. This debt is secured by a pledge of the full faith and credit of the state. Additionally, the state had authorized \$3.5 billion general obligation debt that remained unissued.

The state had revenue debt outstanding at June 30, 2003, of \$830 million, an increase of \$507 million over Fiscal Year 2002. This increase is primarily related to limited revenue bonds issued by the Tobacco Settlement Authority (TSA), a blended component unit of the state. The bonds of the TSA do not constitute either legal or moral obligations of the state, nor does the state pledge its full faith, credit or taxing power for payment of these bonds. Revenue bond debt is secured by specific sources of revenue.

Five times during the year, the state issued general obligation debt, totaling \$1.5 billion, for various capital and transportation projects as well as for refunding purposes. The state took advantage of the historically low interest rates that prevailed through Fiscal Year 2003 to do three refunding bonds and one certificate of participation refunding. These refundings will save taxpayers over \$65 million (net present value) in future interest payments. The state ranked 18<sup>th</sup> in a list of the top 100 issuers ranked by amount financed by municipal issuers in calendar year 2002, according to *The Bond Buyer's 2003 Yearbook*.

### State of Washington's Bond Debt

(in millions of dollars)

	Governmental Activities		Business-type Activities		Total	
	2003	2002	2003	2002	2003	2002
General obligation (GO) bonds	\$ 8,376	\$ 7,997	\$ 172	\$ 187	\$ 8,548	\$ 8,184
Accreted interest on zero interest rate GO bonds	153	152	18	15	171	167
Revenue bonds	-	-	830	323	830	323
Total	<u>\$ 8,529</u>	<u>\$ 8,149</u>	<u>\$ 1,020</u>	<u>\$ 525</u>	<u>\$ 9,549</u>	<u>\$ 8,674</u>

The Washington State Constitution and the Revised Code of Washington limit the amount of general obligation (GO) debt that may be issued, the latter being the most restrictive. For the fiscal year ended June 30, 2003, the maximum GO debt authorized by statutory limit was \$6.47 billion. The state had \$5.69 billion of debt outstanding as of June 30, 2003, that was subject to the limitation. Specific bond issues and types that are not secured by general state revenues, such as motor fuel tax and reimbursable bonds, are excluded from the limitation.

By statutory provision, the State Finance Committee (SFC) is authorized to supervise and control the issuance of all state bonds, notes, or other evidences of indebtedness. The SFC is composed of the Governor, Lieutenant Governor and State Treasurer, the latter serving as chairman.

In July 2002, Standard & Poor's Rating Group (S&P) removed the state of Washington general obligation debt from CreditWatch, citing the state's adoption of the 2002 supplemental budget, balancing the 2001-03 biennial budget. S&P maintained the existing negative outlook. No other rating agency actions occurred during the fiscal year.

As of June 30, 2003, the state of Washington's general obligation debt was rated Aa1 (negative outlook) by Moody's Investor Service, AA+ (negative outlook) by S&P, and AA (stable outlook) by Fitch Ratings.

Additional information on the state's bond debt obligations and the calculation of the legal debt limitation is presented in Note 7 beginning on page C57 of this report.

### **Economic Factors and Next Year's Budgets and Rates**

- During the next two years, the state is expected to show signs of a slow recovery from the recession that impacted the state during the 2001-03 Biennium.
- Revenue forecasts for the 2003-05 Biennium reflect fairly static growth in General Fund revenues.
- Employment is expected to show signs of improvement comparable to projected national growth rates.

Legislative leaders and management will consider these factors in preparing the state's budget for future years.

### **Requests for Information**

This financial report is designed to provide a general overview of the state of Washington's finances for all those with an interest in the government's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Office of Financial Management, PO Box 43113, Olympia, WA 98504-3113.